IN THE

Supreme Court of the United States

October Term, 1974

Nos. 74-157 and 74-647

UNITED HOUSING FOUNDATION, INC., *et al.*,
Petitioners,

v.

MILTON FORMAN, *et al.*,
Respondents,

and

THE STATE OF NEW YORK and THE NEW YORK STATE HOUSING FINANCE AGENCY,
Petitioners,

v.

MILTON FORMAN, *et al.*,
Respondents.

BRIEF FOR PETITIONERS UNITED HOUSING FOUNDATION, INC., *et al.*

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Opinions Below

The opinion of the United States Court of Appeals for the Second Circuit, reported at 500 F.2d 1246 (2d Cir. 1974), is reprinted as Appendix A to the petition for cer-

tiorari in No. 74-157.[1] The opinion of the United States District Court for the Southern District of New York, reported at 366 F.Supp. 1117 (S.D.N.Y. 1973), is reprinted as Appendix B to the petition in No. 74-157.

Jurisdiction of This Court

The judgment of the Court of Appeals (P-C1-2) was entered on June 12, 1974. The petition for certiorari in No. 74-157 was docketed on August 22, 1974. The petition in No. 74-647 was docketed on November 22, 1974. This Court granted the writ and consolidated the cases on January 20, 1975. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Statutes and Rule Involved

This case involves Sections 2(1), 17(a) and 22(a) of the Securities Act of 1933, 15 U.S.C. §§ 77b(1), 77q(a) and 77v(a); Sections 3(a)(10), 10(b) and 27 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78c(a)(10), 78j(b) and 78aa; and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, the texts of which are set forth in pertinent part in the appendix to this brief.

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1. References to the appendices to the petition for certiorari in No. 74-157 are prefaced by "P-" followed by the appendix letter and page number, *e.g.*, (P-A10). References to the Single Appendix in this case are designated by "A" followed by the page number, *e.g.*, (A2). References to the appendix submitted to the Court of Appeals below are designated by the page number followed by "a," *e.g.*, (160a).

Question Presented

Is a membership in a cooperative housing corporation, to which neither the promise, the expectation nor the possibility of profit attaches, a "security" as defined in the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act")—(collectively, the "securities laws")—particularly when it arises out of the following circumstances:

1. A state legislature determines, as a matter of social policy, to take state action to remedy a serious housing shortage for low and middle income groups and adopts legislation to encourage the construction of low and middle income housing by furnishing substantial subsidies;

2. Under that legislation, a nonprofit foundation composed of labor unions, housing cooperatives and civic groups sponsors a massive nonprofit cooperative housing development, the planning, construction and initial management of which is pervasively controlled by the State in accordance with the statutory scheme;

3. Membership in the cooperative corporation:

(a) is purchased solely in order to secure a personal residence;

(b) is accompanied neither by promise of profit by the seller nor expectation of profit by the buyer;

(c) can be resold only when the member moves out and only for exactly the price paid; and

(d) is evidenced by two instruments: (i) a lease entitling the member to occupy a specific apartment, and (ii) a certificate called "stock" which reflects the member's participation in the residential cooperative corporation?

The State of New York and The New York State Housing Finance Agency, petitioners in No. 74-647, raise, as an additional question, their immunity to suit in federal court under the securities laws and the Eleventh Amendment to the United States Constitution, discussed in their separate brief.

Statement of the Case

The issue before this Court is whether a federal court has jurisdiction to hear a dispute over increases in monthly carrying charges (rent) for residents of a state financed and regulated low and middle income housing cooperative. The Court of Appeals for the Second Circuit, reversing the District Court for the Southern District of New York, decided that this case was properly in the federal courts. It held that membership in a nonprofit low and middle income cooperative housing corporation built pursuant to an emergency state housing program, and with respect to which profit incentives—as that term is ordinarily understood—are totally absent, is nevertheless a "security" as defined by the securities laws.

This unprecedented decision superimposes federal jurisdiction upon a complex state social welfare program available exclusively to low and middle income families. It

construes the statutes at issue in a manner expressly rejected by other Courts of Appeals. It creates a new class of federal litigants by misapplying statutes designed to regulate conduct in the investment marketplace. It undermines the definition of an investment contract established by this Court and conflicts with published guidelines of the Securities and Exchange Commission. Finally, it intrudes federal law into an area of important state concern without congressional sanction and is, indeed, inconsistent with recent congressional enactments in the field of cooperative housing.

The Parties and Proceedings Below

Respondents are 57 residents of Co-op City, a massive low and middle income cooperative housing development located in Bronx County, New York City, and built under New York State's pioneering Mitchell-Lama Housing Law.[2] Respondents instituted this action purportedly on behalf of a class consisting of all the owners of Co-op City's more than 15,000 apartments, and derivatively on behalf of the cooperative corporation.

Petitioner United Housing Foundation, Inc. ("UHF"), the sponsor of Co-op City, is a nonprofit membership corporation composed of labor unions, housing cooperatives and other civic groups (160a). Founded in 1951, it is widely regarded as a pioneer and leader in the development of low and middle income housing cooperatives[3] and has

2. N.Y. Private Housing Finance Law §§10-59 ("Housing Law").

3. *Building the American City,* Rep. of Nat'l Comm'n on Urban Problems to Congress and the President, H.R. Doc. 91-34, 91st Cong., 1st Sess. 136-39 (1968).

sponsored numerous cooperative developments under the Housing Law and related statutes.[4]

Petitioner Community Services, Inc. ("CSI"), is a wholly-owned subsidiary of UHF and acts as general contractor and sales agent for UHF-sponsored cooperatives. The individual petitioners are some of the officers and directors of UHF, CSI and Riverbay Corporation, the cooperative housing company organized under the Housing Law to own and operate Co-op City.

Petitioner The State of New York (the "State"), through its Division of Housing and Community Renewal, controlled and supervised all aspects of the planning and construction of Co-op City and continues to control and supervise its operation. Petitioner The New York State Housing Finance Agency (the "Agency") is a corporate governmental agency of the State. It furnished a forty year, low interest mortgage loan to Riverbay Corporation to finance the construction of the development.

Respondents instituted this action in September 1972 in the United States District Court for the Southern District of New York, seeking reduction of their monthly carrying charges, money damages and other relief. Federal jurisdiction was based on two claims alleging violations of anti-fraud provisions of the securities laws. In essence, these claims charge that Information Bulletins (159-200a) distributed by petitioners misled prospective cooperative members with respect to construction costs and estimated

4. UHF has sponsored Rochdale Village in Queens; Amalgamated Warbasse Houses in Brooklyn; Penn Station South, Seward Park Houses and East River Houses in Manhattan; and other projects (67a).

monthly carrying charges. Ten state-law claims are joined in the complaint under the doctrine of pendent jurisdiction.[5]

In December 1972, petitioners moved to dismiss the complaint on the ground that Co-op City cooperative memberships were not "securities" as defined in the securities laws and that, accordingly, the court lacked subject matter jurisdiction. The State and Agency also moved to dismiss the complaint as to them on the grounds that they were immune from such suit in federal court and were not persons under 42 U.S.C. §1983. The District Court granted petitioners' motions with respect to subject matter jurisdiction[6] and dismissed the complaint in its entirety.

Respondents appealed, and on June 12, 1974, the Court of Appeals for the Second Circuit reversed. It held that there was subject matter jurisdiction because Co-op City memberships were "securities." In addition, it held that, by participating in the cooperative development, the State and Agency had waived immunity from suit in federal court.

The Factual Background

Co-op City was conceived in 1964. Government officials, including the Governor of New York and the Mayor of New York City, working with UHF, determined that a large tract of vacant land in the Bronx was ideally suited for a low and middle income cooperative apartment development under the Housing Law. UHF was selected to sponsor the project (71a).

5. An additional federal claim was asserted under the Civil Rights Act, 42 U.S.C. §§1983, 1988, and 28 U.S.C. §§1331, 1343, solely against the Agency.

6. Accordingly, the District Court did not reach the additional issues raised by the State and Agency.

In accordance with the Housing Law, the State Division of Housing and Community Renewal and its Commissioner exercised continuing supervision over the planning and construction of the development (71-73a). All plans, projections, budgets, financial needs and other matters were submitted to the Division for review (*Id.*). The Division's Bureau of Finance and Audit reviewed financial computations. The Bureau of Construction reviewed and approved construction estimates. The Commissioner or his deputy approved the 1965 construction contract and all subsequent modifications (212a, 219a, 223a, 226a, 233a, 242a). Insurance matters, maintenance and operating schedules and legal matters were all sent to appropriate bureaus within the Division, and the Commissioner or his deputy approved agreements concerning them (72-73a, 321a, 324a, 327a, 332a, 336a, 339a).

Thus, the Commissioner determined and continues to determine the propriety of practically every dollar expended, as well as the initial and all subsequent carrying charge levels (73a). Such strict supervision and control by the State is mandated by law. Indeed, as the District Court found, beginning with the initiation of a project and continuing thereafter, "state control is pervasive" (P-B7).

Preliminary planning for Co-op City took more than a year. In July 1965, after the State had reviewed all plans and issued necessary approvals, the newly-formed Riverbay Corporation obtained mortgage funds from the Agency and began construction (73a).[7]

7. Under the financing plan adopted by the State and the Agency, 92.2% of the cost of construction of Co-op City was provided by the Agency through long term, low interest mortgage loans. The remaining 7.8% came from funds contributed by those purchasing Co-op City cooperative shares (347a, Sched. B).

Co-op City took seven years to build. It consists of over 15,000 apartment units in townhouses and 35 high-rise apartment buildings, spread over two hundred acres. It has stores, garages, schools, public auditoriums, parks and playgrounds and places of worship. It is, in effect, a new city, today housing approximately 50,000 people on a site which, just ten years ago, was an abandoned amusement park.

During the long construction period, the cost of building this new city increased substantially over original estimates. Because of the increases in construction costs, development costs, operating expenses, interest rates and taxes (76a), the average "per room" monthly carrying charge increased from $23.02 estimated in the 1965 Information Bulletin furnished to prospective members (174a), to an estimated $25.00 per room in the 1967 Information Bulletin (194a). No one had moved into Co-op City at this time (77a). The carrying charge figure increased again in 1970 and in two additional stages in 1973 and 1974 to the present average monthly charge of $40 per room (77a, P-B11). All increases in construction costs, in other costs and in carrying charges were fully reviewed and approved by the Commissioner as required by law (362a).[8]

Subscribers for Co-op City shares were advised of the increases in costs and carrying charges (*e.g.*, 101-03a). Those who wished to withdraw were permitted to do so,

8. The District Court found that, despite the significant increases in the construction costs, Co-op City apartments remain outstanding bargains, in great part because of their low unit cost of $19,000 compared with the $40,000 per unit average for other Housing Law projects built during the same period (P-B11 n.27).

and received a refund of their purchase price (393a). Indeed, every member who has withdrawn from the cooperative during its ten year history has received a full refund.[9]

The respondents claim, in essence, that they were not adequately advised of the possibility of increases in construction costs and carrying charges.[10] They seek to justify federal jurisdiction for their claims on the theory that the Co-op City memberships they hold are "securities."

The Co-op City Memberships

As the first step in securing an apartment in Co-op City, a prospective member completes a "Subscription Agreement and Apartment Application" (104-07a). The Agreement provides for the issuance of a number of shares proportionate to the number of rooms in the apartment requested, and it contains an application for a non-proprietary Occupancy Agreement (105a). The completed Agreement, with the required financial information, is submitted to the State for approval (84a; *cf.* 112a). All members must meet the income eligibility requirements of the Housing Law §31(2)(a), (b).

Following State approval of his application, and when an apartment becomes available, the prospective member enters into an Occupancy Agreement with the cooperative (85a). In form, the Occupancy Agreement is an apartment

9. In fact, since the decision of the Court of Appeals, the first-named respondents, Milton and Ellen Forman, moved from Co-op City and received a full refund of the purchase price of their shares. (Other named respondents still reside in Co-op City.)

10. Both courts below expressly disclaimed any inference as to the merits of the case (P-A3, 19 n.11, 22; P-B12 n.28).

lease se and sets forth the monthly carrying charges and the right hts, duties and obligations of the parties (108-19a). Unlik like an ordinary lease, however, the Occupancy Agreement nt provides that, upon its termination, or if the member vacat cates the apartment for any reason, the member must first offer er his shares to the cooperative or its designee on the t terms set forth in the cooperative's by-laws (117a). Thus us, ownership of Co-op City shares is entirely dependent upon on occupancy of a Co-op City apartment. Further, there is no no right to sublet (111a).

C Co-op City's by-laws provide that a departing member must st first offer his shares to the cooperative or its designee for " "par value," which is the purchase price paid by the meml mber (87a). Even if the cooperative should refuse to buy, y, however, the tenant is barred from realizing any profit becau ause, under Housing Law §31-a, he cannot receive more for th the stock than his purchase price plus a fraction of his alloca ocable share of the mortgage amortization. Thus, as both th courts below found, there is no possibility of profit on resal ale (P-A6, 16; P-B8-9, 19).

T The by-laws restrict sale, alienation or encumbrance of a r a member's shares (131-32a, 135-36a). They also provide that t each member shall have a single vote (123a). The numb mber of shares held thus has no bearing upon voting right hts. Moreover, the member's monthly carrying charges are u unrelated to the shares held. Those charges, set forth in eac each Occupancy Agreement, are based on apartment size, type, e, location, height and other amenities (89a).

T Thus, although Co-op City's cooperative members subscrib ibe to instruments formally denominated "stock," the

instruments bear little similarity to conventional stock and other forms of securities found in the investment and business communities.

1. Cooperative members purchase their "stock" (at the rate of $450 per room) solely in order to enjoy the right to occupy a Co-op City apartment. All of their rights and obligations as tenants are set forth in an Occupancy Agreement entered into at the time of purchase. The acquisition of "stock," which does not provide the possibility of dividends or appreciation in value, is incidental. It is merely evidence of membership in the cooperative. It has no independent significance or meaning.

2. Cooperative members can sell their "stock" only when they vacate their apartments and only for the price they have paid.

3. All those who have asked to withdraw from the cooperative, before or after occupancy of their apartments, have been able to do so and have received full refunds of their purchase price.

4. The cooperative members are the beneficiaries of substantial State and City subsidies designed to enable low and middle income State residents to own their own homes. These subsidies are in the form of long term, low interest mortgage loans from the Agency covering 92.2% of the project cost and a real estate tax abatement from New York City which reduces the annual taxes by approximately 80%.

5. Initial and continued eligibility for cooperative membership is limited by law to low and middle income persons,

and members are required to submit annual income statements to the cooperative (112a). The prospective cooperative members are fully advised that the cooperative will not earn any profits nor pay them any income. They are not induced to purchase by any promise of, nor can they expect any, profit, gain or other financial reward.

6. Phrases commonly used in promoting sales of securities or other investments are conspicuously absent from the Information Bulletins and other documents furnished to prospective members.[11]

The Decisions Below

The District Court held that there was no subject matter jurisdiction because Co-op City memberships were not securities within the meaning of the securities laws, and it dismissed the complaint.

Rejecting a literal approach to the definition of "security" and heeding the admonitions of this Court to disregard form for substance, the District Court looked instead to the economic reality of the transactions at issue. The

11. In their place are descriptions such as the following:

"The purpose of a cooperative is to provide home ownership, not just apartments to rent. The community is designed to provide a favorable environment for family and community living. If you have lived in a private apartment house you were the tenant and someone else the landlord. The landlord's interest was in financial gain. There was no common interest between the tenants. You may have lived in the same apartment for years without getting to know your neighbors.

"The common bond of collective ownership which you share makes living in a cooperative different. It is a community of neighbors. Home ownership, common interests and the community atmosphere make living in a cooperative like living in a small town" (166a).

It should also be noted that the Information Bulletins were reviewed and approved by the Commissioner.

essential characteristics of Co-op City cooperative shares, it found, set them apart from conventional stock. That same economic reality, particularly the fundamental nonprofit nature of transactions in Co-op City shares, buttressed the Court's conclusion that the shares were not investment contracts:

> "[N]one of the documents involved in this transaction . . . ever, once use material, tangible profits as an inducement . . . . [I]t is clear that the Co-op City residents did not purchase the shares with any expectation of profits, as the word is generally used in commerce. These shares are incapable—by law and by-law—of producing any monetary or fungible return." (P-B21-22; footnotes omitted)

In response to respondents' arguments that the cooperative members' expectations of below market housing costs furnished the "profit" motive necessary to bring the transactions within the scope of the securities laws, the District Court stated:

> "[I]t seems certain that Congress never intended to stretch the scope of the securities acts outside the commercial world and its fungible valuables, to the uncharted and unchartable realm of intangible, elusive personal values where one man's balm may very well be another's bane." (P-B26)
>
> • • •
>
> "Congress did not intend to sweep into the ambit of the federal securities laws, state-encouraged, nonprofit transactions made pursuant to a state emergency housing law and available only to state residents." (P-B28)

The Court of Appeals reversed. Expressly adopting a "literal approach," it construed the definitional sections of

the statutes to mean that any instrument labeled "stock" is, without more, covered by the securities laws.

> "[T]he fact that 'stock' certificates are used in a 'stock' corporation is sufficient in itself to bring transactions in the 'stock' within the literal definition of the Acts." (P-A11)

The Court of Appeals alternatively held that Co-op City shares were also investment contracts and thus securities under the securities laws. It recognized that expectation or inducement of profit is an essential element of an investment contract and conceded that "there is no possible profit on a resale of the stock" (P-A16). Nevertheless, the Court found "profit" flowing from the ownership of Co-op City shares because (a) income from leased commercial space might reduce cooperative members' monthly carrying charges; (b) personal income tax deductions of mortgage interest payments and real estate taxes might be taken by cooperative members; and (c) Co-op City housing costs substantially less than equivalent housing in the open market and thus results in a saving of an expense to the cooperative members (P-A16-17).[12]

Summary of Argument

An eligible purchaser can buy shares in Co-op City for only one purpose—to obtain an apartment for use as a fulltime personal residence for himself and his family. He does not purchase in the hope of earning an annual income or return since he knows he is required to occupy the apartment and cannot sublet it. He does not purchase

12. In addition, the Court of Appeals found that the State and the Agency had waived their immunity from suit in federal court.

for capital appreciation because he cannot sell the shares for more than he paid. Such a purchase of a personal residence, which cannot be sold at a profit, is clearly not the purchase of a security subject to federal statutes enacted to regulate securities markets and business practices in the world of commerce.

The Court of Appeals' rigid adherence to a literal statutory construction is contrary to congressional intent, the decisions of this Court and the decisions of other Courts of Appeals. The securities laws were not intended to be applied woodenly, without regard to commercial context or economic reality. Their literal application here has resulted in the anomalous extension of the securities laws to transactions remote from the world of commerce, investment and speculation.

The Court of Appeals' alternative holding that Co-op City cooperative shares are investment contracts flies in the face of decisions of this Court defining investment contracts. By defining profit so broadly as to include the benefits of a public welfare program, the Court below effectively eliminated the essential element of profit from the definition of an investment contract.

The Court of Appeals' decision that Co-op City's nonprofit shares are investment contracts also conflicts with guidelines recently issued by the Securities and Exchange Commission. The guidelines state that group-owned housing units are not securities where, as here, the purchase is for personal residential use but will be considered securities only where there is an inducement of profit as that term is ordinarily used in commerce—"an opportunity

through which the purchaser may earn a return on his investment."

Finally, the blanket application of the securities laws to transactions in state subsidized low and middle income housing cooperative residences intrudes federal law into an area of great state concern without congressional sanction. Particularly where, as here, an innovative and important state housing program is involved, this Court should require a clear congressional mandate. Not only has Congress not issued such a mandate, but its recent enactments with respect to cooperative housing are totally inconsistent with application of the securities laws. Congress has recently directed the Department of Housing and Urban Development ("HUD"), not the SEC, to study whether federal regulation of abuses in cooperative and condominium housing sales is required. That legislative decision should be respected.

ARGUMENT

I

The Literal Approach to the Definition of a Security Is Contrary to Congressional Intent and Judicial Decision.

The Court of Appeals held Co-op City's cooperative shares to be "securities" because they are called "stock." Adopting a "literal approach" to the definition of security in the securities laws, it held:

> "[T]he fact that stock certificates are used in a 'stock' corporation is sufficient in itself to bring transactions

in the 'stock' within the literal definition of the Acts" (P-A11).[13]

The Court of Appeals' wooden application of the statutory language is inconsistent with the statutes' intent and purpose, conflicts with this Court's decisions and with the decisions of other Circuits and will produce illogical and arbitrary results.

A. Congressional intent requires that commercial context be considered.

Section 3(a)(10) of the 1934 Act, 15 U.S.C. §78c(a)(10), provides:

> "(a) When used in this chapter, *unless the context otherwise requires*—
>
> * * *
>
> (10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity

13. The Second Circuit subsequently extended its holding here to a private, luxury cooperative. 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375 (2d Cir. 1974). In so doing, the Court noted, "First, we ground our decision on what has been characterized as the 'literal approach'." *Id.* at 1378.

> at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." (emphasis added)[14]

The introductory phrase "unless the context otherwise requires" mandates against a strict literal approach and requires that a court consider whether a suggested construction is consistent with the purpose of the statutes.

The legislative history of the securities laws demonstrates that substance rather than form should control. The laws were enacted in order to govern conduct in the commercial marketplace and to curb the unhealthy and predatory financial practices which helped precipitate the Depression. The thousands of pages of committee reports, hearings and debates focused on the stock market manipulations, margin abuses, and reckless stock market gambling of small investors who were lured on by the market-makers' siren song of "[a]lluring promises of easy wealth," and who were inevitably "sheared like lambs" by unethical financiers.[15] To reach these abusive schemes, Congress purposely defined the term "security" in

> "sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. Rep. No. 85, 73d Cong.,

14. The 1933 Act's definition, §2(1), 15 U.S.C. §77b(1), is "virtually identical." Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

15. H.R. Rep. No. 85, 73d Cong., 1st Sess. 2-3 (1933); 78 Cong. Rec. 7717 (1934). *See* 1934 Act, §2; S. Rep. No. 792, 73d Cong., 2d Sess. 1-4 (1934); 77 Cong. Rec. 2916-19 (1934) (Rep. Rayburn); 78 Cong. Rec. 2270-71 (1934) (Sen. Fletcher); *and, e.g.*, 78 Cong. Rec. 7689-90 (Rep. Sabath); 78 Cong. Rec. 7921, 8163-64, 8175, 8387 (1934).

1st Sess. 11 (1933); *cf.* S. Rep. No. 792, 73d Cong., 2d Sess. 5 (1934)

But Congress also indicated that it did not intend to extend federal regulation to those instruments "not regarded in the commercial world as securities offered to the public for investment purposes." H.R. Rep. No. 85, *supra*, at 15.[16] Co-op City's nonprofit memberships, which are not ever available to the commercial world, are certainly not "offered to the public for investment purposes."

B. Judicial decisions adopt a pragmatic, not a literal, approach.

Consistent with the legislative purpose, this Court has recognized that a security cannot be defined in a vacuum. The substance of an instrument and its commercial character must be considered. In *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967) this Court stated:

> "[I]n searching for the meaning and scope of the word 'security' . . ., form should be disregarded for substance and the emphasis should be on economic reality." *Id.* at 336 (citation omitted)

The Court in *Tcherepnin* unanimously held that withdrawable capital shares of an Illinois savings and loan association were securities under the 1934 Act. The shares entitled their holders to dividends based on an apportionment of the association's profits: this made the shares investment contracts. The Court alternatively held that the

16. Insurance policies were thus explicitly exempted on the grounds that they, and "like contracts," are not ordinarily regarded as investment securities. The House Committee thought that the exclusion could be implied from the "entire tenor of the act," but the specific exclusion was made "to make misinterpretation impossible." *Id.* at 15. *See also*, Collins v. Baylor, 302 F.Supp. 408 (N.D. Ill. 1969).

right to an apportionment of profits made the instruments "stock," although they were not labeled "stock." *Id.* at 338-39. Thus, the Court considered the rights the instrument created and ignored the label.[17]

In *Kern County Land Co.* v. *Occidental Petroleum Corp.*, 411 U.S. 582 (1973), this Court used a pragmatic approach to exclude a transaction from the coverage of §16(b) of the 1934 Act, even though the transaction was literally a short-swing "sale" within the 1934 Act's definition of "sale," §3(a)(14). The Court stated:

> "The statutory definitions of 'purchase' and 'sale' are broad and, at least arguably, reach many transactions not ordinarily deemed a sale or purchase. In deciding whether borderline transactions are within the reach of the statute, the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to insider information—thereby endeavoring to implement congressional objectives without extending the reach of the statute beyond its intended limits." *Id.* at 593-95 (footnotes omitted)

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17. Indeed, this Court has long spoken out against the literal application of statutory language. Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892) ("It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers"); CAB v. Delta Air Lines, Inc., 367 U.S. 316, 328 (1961) ("[Literalism] 'has all the tenacity of original sin and must constantly be guarded against' "). In Cabell v. Markham, 148 F.2d 737, 739 (2d Cir.), *aff'd*, 326 U.S. 404 (1945), Judge Learned Hand wisely remarked that it is an error "to make a fortress of the dictionary." *See* Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 537 (1947).

Thus the Court held that the transactions in *Kern* were not "sales" as defined in the statute because they did not offer the potential for insider trading and speculative abuse which §16(b) was intended to prevent.

The Court of Appeals' error in holding that all "stocks" are automatically securities under federal law is highlighted by the contrary approaches recently adopted by the Third, Fifth and Seventh Circuits. In *Lino* v. *City Investing Co.*, 487 F.2d 689 (3d Cir. 1973), the Third Circuit held the "note" in issue not a security, although the statute literally makes "any note" a security. In rejecting a literal construction, the Court stated:

> "[I]t is our view that the legislation was not intended to cover the transaction which occurred here. All of the definitional sections involved in this case are introduced by the phrase *'unless the context otherwise requires.'* The commercial context of this case requires a holding that the transaction did not involve a 'purchase' of securities." *Id.* at 694 (emphasis in original)

In *McClure* v. *First National City Bank of Lubbock*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, —— U.S. —— (1975), the Fifth Circuit rejected a literal approach and held that a commercial promissory note not made for investment purposes was not a security within the meaning of the 1934 Act.

And in *C.N.S. Enterprises, Inc.* v. *G. & G. Enterprises, Inc.*, CCH FED. SEC. L. REP. ¶94,938 (7th Cir. Jan. 13, 1975), the Seventh Circuit refused to follow a literal construction of "any note," and held that an ordinary commercial loan

transaction in which a note was given was not a securities transaction.[18]

• • •

Under the "literal approach," the name given an instrument, without more, determines whether transactions in it are covered by the securities laws. But housing cooperative "stock" is also called a "membership," and condominiums use deeds. The form of organization is dictated by tax laws, zoning, state and local regulation and custom—considerations unrelated to the securities laws. With respect to group-owned housing units, reliance on the literal words of the statutes to impose securities law jurisdiction leads to inconsistent and illogical results.[19] Thus Co-op City, whose memberships are called "stock", has been held subject to federal jurisdiction, while similar housing developments under private ownership and control can exempt themselves merely by choosing another form and label.

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18. *See also* Bellah v. First Nat'l Bank of Hereford, 495 F.2d 1109 (5th Cir. 1974); Vincent v. Moench, 473 F.2d 430 (10th Cir. 1973); Thorp Commercial Corp. v. Northgate Industries, Inc., CCH FED. SEC. L. REP. ¶94,929 at 97,213 (D. Minn. Dec. 4, 1974) ("The Federal securities laws are not intended to protect banks and finance companies from fraud by a borrower in an ordinary commercial loan transaction. These institutions must turn to State law for relief").

19. In New York, the cooperative form prevailed for many years, but recent state legislation authorizing condominiums has resulted in a number of condominium developments. Thus, in New York City, one apartment building may be a cooperative while an otherwise identical neighboring building is a condominium. One new building in New York City is part cooperative and part condominium. Adopting a "literal approach" would lead to the absurd result that the documents evidencing ownership of an apartment on one floor of this building would be a "security" while analogous documents evidencing ownership of the same apartment on another floor would not. *See* Innovations Modifying Apartment Design, N. Y. Times, Feb. 23, 1975, sec. 8, p. 10, col. 2; *see also* note 31, *infra*.

Professor Loss, thus, rejects the literal approach as it applies to residential cooperatives, stating:

> "[S]ubstance governs rather than form: . . . just as some things which look like real estate are securities, some things which look like securities are real estate." 1 Loss, Securities Regulation 493 (1961) (footnote omitted)

II

Co-op City Memberships Are Not Investment Contracts.

The pragmatic approach to the definition of a security requires the court to examine the character of the instrument at issue and the economic context in which it is used. This examination, as both courts below agreed, is in essence the application of the investment contract test.

This Court first defined the investment contract concept more than thirty years ago in *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943):

> "The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."

Three years later, in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 301 (1946), the Court refined its definition:

> "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[20]

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20. Tcherepnin v. Knight, 389 U.S. at 338, reaffirms *Joiner* and *Howey* and applies them to the 1934 Act.

Joiner and *Howey* together established two related avenues of inquiry to determine whether an instrument is an investment contract—the economic inducement offered by the promoter and the purchaser's expectation of profits from efforts of others. While acknowledging the validity of these tests, the Court of Appeals misapplied them.

A. There was no inducement of profit.

The promise of monetary profit on one's investment—the inducement of substantial financial return—is a central and indispensable element of every investment contract. In *Joiner*, this Court said:

> "Undisputed facts seem to us, however, to establish the conclusion that defendants were not, as a practical matter, offering naked leasehold rights. *Had the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well, it would have been quite a different proposition.*" 320 U.S. at 348 (emphasis added)

In *Howey*, the promoters had represented that profits from the investment could be 20% or greater. 328 U.S. at 296. *Cf. SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202, 211 (1967).[21]

21. The circuit courts, other than in the decision below, in finding the investment contract test satisfied, have uniformly found that promoters held out the prospect of substantial financial gain. *See, e.g.*, SEC v. Haffenden-Rimar International, Inc., 496 F.2d 1192 (4th Cir. 1974), *aff'g* 362 F. Supp. 323 (E.D. Va. 1973) (seller predicted 20-25% annual return, doubling investment in four years); Nor-Tex Agencies, Inc. v. Jones, 482 F.2d 1093 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 475 (5th Cir. 1974) ("Koscot thrives by enticing prospective investors to participate in its enterprise, holding out as a lure the expectation of galactic profits"); Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027, 1034 (2d Cir. 1974) (the promoters

(footnote continued on next page)

It is unquestioned that the sale of Co-op City shares was not accompanied by such profit inducement. The Co-op City Information Bulletins contain no representations with respect to potential profit or income. Indeed, the District Court concluded—and this finding was undisturbed by the Court of Appeals—

> "that none of the documents involved in this transaction . . . ever, once use material, tangible profits as an inducement. In fact, the Information Bulletins assert the contrary, impressing upon the potential purchaser the stability of environment to be achieved because the shares cannot be used for speculation." (P-B21-22; footnote omitted)

In short, the Co-op City Information Bulletins do not promise "galactic profits" or offer the opportunity to engage in speculation or make a return on an investment. Instead the Bulletins stress the virtue of an apartment in a stable community and a membership in "a nonprofit enterprise owned and controlled democratically by its members" (162a). The inducement of the Co-op City offering is not profit, but housing; not a return on an investment contract, but an apartment to live in.

"virtually guaranteed" investors that they would "'double their money' in four years"); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 479, 842 (9th Cir.), *cert. denicd*, 414 U.S. 821 (1973) (Turner was selling a "sure route to great riches," a "get-rich-quick scheme"); Continental Marketing Corp. v. SEC, 387 F.2d 466, 470 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968) (promise of "geometric profits").

The SEC has also repeatedly stressed the importance of the economic inducements offered by the promoter, *e.g., Offers and Sales of Condominiums or Units in a Real Estate Development*, SEC Securities Act Release No. 5347 (Jan. 4, 1973) (P-D9); [*Multi-level Distributorships and Pyramid Sales Plans*], SEC Securities Act Release No. 5211 (Nov. 30, 1971), 1 CCH FED. SEC. L. REP. ¶1048.

B. There is no expectation of profit.

An investment contract requires not only the offeror's inducement of economic gain but also the offeree's expectation of profit. *SEC* v. *W. J. Howey Co., supra.*

Both courts below agreed that purchasers of Co-op City memberships do not expect the kind of profit ordinarily associated with a security—appreciation in market value and receipt of dividends. Both courts found that, under the cooperative's by-laws and the Housing Law, there is no possibility of profit from the resale of shares in Co-op City (P-A16, P-B22; Housing Law §31-a).[22] As stated by the District Court:

> "It is clear that the Co-op City residents did not purchase the shares with any expectation of profits, as the word is generally used in commerce. These shares are incapable—by law and by-law—of producing any monetary or fungible return." *Id.*

In reversing, the Court of Appeals did not find that these cooperative shares could generate profit as that word is ordinarily used in commerce. Nor did it find any inducement, promise or expectation of profit, as previously defined by the federal courts. Instead, the Court found "an expectation of 'income' " from three sources: (1) reduced carrying charges resulting from the rental of commercial facilities in the common areas of the project; (2) tax deductions allowed cooperators for interest and real

22. *Cf.* Stoneridge Golf and Country Club, SEC No-Action Letter, Jan. 3, 1975 (avail. Feb. 2, 1975), *noted in* BNA SEC. REG. L. REP. No. 289 (Feb. 12, 1975) at C-1-2. The determinative factor in the issuance of a no-action letter exempting the sale of golf club memberships from registration was the inclusion in the club's by-laws of a provision prohibiting the resale of the memberships at a price higher than the initial purchase price.

estate taxes; and (3) "the saving of an expense which would otherwise necessarily be incurred" (P-A16-17). This unprecedented expansion of the concept of a profit cannot be sustained.

1. *Rents from commercial facilities are not profit*—Co-op City was built on 200 acres of undeveloped land in the Bronx (169a). To provide for the residents' basic needs, the development includes parking garages, laundry facilities and community service centers which contain retail shops such as grocery stores and pharmacies, professional offices, community facilities, and schools, all patronized and used by the tenants. Tenants pay for parking privileges and for use of laundry machines, and the commercial establishments pay rent. Although the record is silent as to the income earned from these services (as this point was first raised by respondents in the Court of Appeals), the Court below nonetheless concluded that residents of Co-op City "may share . . . in substantial income, not in the form of dividend checks but in reduced monthly carrying charges" (P-A16).[23]

Even accepting the Court's unsupported finding that the rental of commercial facilities generates income to the cooperative, this income is not an "expectation of profit" as used in *Howey*. It is undisputed that these commercial facilities are incidental to the project and are included as

23. The Court of Appeals referred to exhibits submitted by respondents in the District Court (351a, Sched. B; 353a, Sched. B). The exhibits contain, among other things, estimates of gross commercial rentals. The Court of Appeals misread the exhibits as stating net rental. Petitioners contend that a full examination of the facts will demonstrate that these facilities do not generate any significant net income.

a necessary service to the residents.[24] The service areas are not—and were never intended to be—a primary source of income; indeed, in describing these facilities, the Information Bulletins do not mention any possibility of income to the cooperative (169a, 190a).

The SEC has rejected the Court of Appeal's view that such income from incidental commercial facilities is profit. In Securities Act Release No. 5347 (Jan. 4, 1973) (P-D5) ("SEC Release No. 33-5347"), the Commission stated, in pertinent part:

> "In situations where commercial facilities are a part of the common elements of a residential project, no registration would be required under the investment contract theory where (a) the income from such facilities is used only to offset common area expenses and (b) the operation of such facilities is incidental to the project as a whole and are not established as a primary income source for the individual owners of a condominium or cooperative unit." (P-D11)

Co-op City's commercial service facilities clearly fall within the SEC guideline.

The SEC release recognizes that the prospect of reduced carrying charges because of income from incidental commercial facility rentals is not the kind of profit that would induce the ordinary investor for whose protection the securities laws were passed to place his money in a residential cooperative. No investor seeking a profit would purchase memberships in Co-op City because of these com-

24. Indeed, under the Housing Law, the construction of commercial facilities in a cooperative project is limited to those which are "incidental and appurtenant" to the project. Housing Law §12(5). Under §216 of the Internal Revenue Code, income from these facilities cannot exceed 20% of the cooperative's gross income. 26 U.S.C. §216 (b)(1)(d).

mercial facilities. Yet no tenant seeking a place to live would move in without them. The commercial facilities make Co-op City a viable and attractive housing opportunity but do not turn it into a profit-making investment of the kind included within the ambit of the securities laws.

2. *Tax deductions are not profit*—The Court of Appeals held that the ordinary homeowner's tax deductions for real estate taxes and mortgage interest are items of profit to Co-op City members (P-A17).

The potential tax deduction, which is neither emphasized in the Information Bulletins nor guaranteed by the sponsor (175a, 195a), "is an incident of real estate ownership, not securities ownership" (P-B22 n.35). Section 216 of the Internal Revenue Code, 26 U.S.C. §216, permits tenants in a cooperative housing corporation to deduct from their personal income tax their proportionate share of the cooperative's mortgage and tax payments. The clear legislative purpose of this section is to place tenants in a cooperative apartment "in the same position as the owner of a dwelling house so far as deductions for interest and taxes are concerned." S. Rep. No. 1631, 77th Cong., 2d Sess. 51 (1942). *See Park Place, Inc.*, 57 T.C. 767, 776 (1972). A shareholder of Co-op City thus can claim a tax deduction because he is homeowner and not because he owns a security.

SEC Release No. 33-5347 does not recognize such ordinary tax deductions as profit which will transform housing into securities. Moreover, the size of the tax saving, if any, a resident of Co-op City derives from Section 216 depends upon his own income level and whether he itemizes

deductions. The deduction is unique to each individual cooperator. It is neither created nor affected by the efforts of others and thus, even if considered an element of profit, does not derive "solely from the efforts of others."

3. *"Saving of an expense" is not profit*—Finally, the Court of Appeals held that the opportunity to obtain housing at or below market cost is profit within the meaning of *Howey* (P-A17-18). This definition of profit, which is unprecedented in federal securities cases, confuses "benefit" with "profit."[25] As the District Court stated:

> "[I]t seems certain that Congress never intended to stretch the scope of the securities acts outside the commercial world and its fungible valuables, to the uncharted and unchartable realm of intangible, elusive personal values where one man's balm may very well be another's bane." (P-B26; *see also* P-B27 n.43)

The "saving of an expense" depends in part on highly subjective personal preferences rather than objectively demonstrable financial gain. Thus, in determining whether the members of Co-op City were induced to become residents by an expectation of savings, the Court will have to consider, for example, such factors as the costs of commuting to work, the relative desirability of living in this community as opposed to others in the New York metropolitan area, the attractiveness of the project and a host of other equally subjective factors. This savings is often incapable of measurement and is completely inconsistent with profit in the ordinary financial sense.

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25. *See* Miller, *Cooperative Apartments: Real Estate or Securities?*, 45 BOSTON U. L. REV. 465, 496, 504 (1965). In 1050 Tenants Corp. v. Jakobson, *supra*, which involved luxury apartments sold at prevailing market rates, the Court of Appeals below stretched this tenuous concept of "profit" to include "optimum services at minimum cost." What is not a "profit" under this test?

In so stretching the concept of profit, the Court of Appeals ignored the essential distinction between purchase for personal use and purchase for financial gain. The recent decisions and administrative rulings in the whiskey warehouse receipt cases illustrate this distinction. The SEC and the courts have consistently recognized that not all purchases of whiskey receipts which result in savings to the purchasers are investment contracts. Instead, the courts and the SEC have examined the purpose of the transaction and distinguished between purchases for personal use (even when bought as a hedge against inflation or to take advantage of a good bargain) and purchases which are part of a money-making scheme contemplating ultimate resale.[26] SEC Release No. 33-5347 implicitly recognizes this distinction as well.

This distinction is fundamental to the proper enforcement of the securities laws. Without it—and if the holding below is allowed to stand—virtually every "common enterprise," every agreement by a group of people to pool their resources to save money, becomes an investment contract subject to federal regulation under the securities laws and to litigation in federal court.

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26. *See, e.g.*, Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d at 1034 ("The evidence below shows that investors put up their money not so much to secure casks of Scotch whiskey but to participate in an enterprise which was virtually guaranteed to 'double their money' in four years"); SEC v. Haffenden-Rimar International, Inc., *supra*; SEC Securities Act Release No. 5018 (Nov. 4, 1969), 1 CCH FED. SEC. L. REP. ¶1047 at 2066.

C. Under SEC guidelines, Co-op City memberships are not investment contracts.

In holding Co-op City memberships to be securities, the Court of Appeals drew support from SEC Rule 235, but ignored recent SEC guidelines in the area of group-owned housing. Indeed, under current SEC guidelines, a Co-op City membership would not be a security.

The SEC's policy of not regulating cooperative residential housing, as opposed to real estate investments, is of long standing. At first the Commission took a formal approach and exempted most residential housing cooperatives from registration. Recently, the Commission adopted more sophisticated guidelines for determining when an offering of housing units involves securities.

The Commission's first pronouncement in this area was SEC Rule 235, 17 C.F.R. 230.235, effective January 9, 1961. As applied by the SEC, Rule 235 exempts from registration stock in virtually all cooperative housing corporations if the principal activity of the corporation is the "ownership, leasing, management or construction of residential properties for its members. . . ."[27] 17 C.F.R. 230.235(b). However, to argue that the existence of Rule 235 demonstrates conclusively that stock in a housing cooperative is

27. Rule 235 exempts cooperatives if the "aggregate offering price" of the stock is below $300,000. The SEC has interpreted this language to create the broadest possible exemption. It has permitted sellers of cooperatives of any size to obtain an exemption if the par value of the cooperative's stock is less than $300,000. *See, e.g.*, 900 Park Ave. Corp., SEC No-Action Letter, June 9, 1972 (avail. July 10, 1972) (exempting offering totalling $11,896,000); Summit House Tenants Corp., SEC No-Action Letter, Jan. 6, 1972 [1971-72 Transfer Binder], CCH FED. SEC. L. REP. ¶78,611 (exempting offering totalling $4,279,293).

a security is, in Professor Loss' words, "too facile." 1 Loss, SECURITIES REGULATION 493-94 (1961).[28] Indeed, according to the 1972 Report of the SEC Real Estate Advisory Committee ("Advisory Report"), appointed by Chairman Casey to undertake a comprehensive review of the applicability of the securities laws to real estate, Rule 235 was adopted "partly in recognition of the fiction of calling cooperative stock 'securities' . . . ."[29] By exempting the whole field, the Commission has avoided this "fiction" and maintained a hands-off policy regarding residential cooperatives.

The Advisory Report,[30] recognizing that the application of the Securities Laws to real estate transactions is too complex to be governed solely by labels, leaves no doubt that a membership in a residential cooperative like Co-op City is not a security within the meaning of the securities laws.

The Committee based its analysis on the principle that the coverage of the securities laws extends to offerings of investment contracts but not to offerings of dwelling units for personal use: "the dwelling unit, of itself, does not constitute a security without additional facts." Advisory Report at 90; *see SEC* v. *C. M. Joiner Leasing Corp.*, 320

28. It has been suggested that "[a] more plausible argument is that an exemptive rule was a convenient means for the Commission to avoid the cooperative housing regulation issue." Recent Development, 62 GEORGETOWN L. J. 1515, 1527 n.62 (1974).

29. Report of the Real Estate Advisory Committee to the Securities and Exchange Comm'n (Oct. 12, 1972), 90 n. 26.

30. The Advisory Report and the SEC response are discussed in Dickey and K-Thorpe, *Federal Security Regulation of Condominium Offerings*, 19 N. Y. L. FORUM 473 (1974). Mr. Dickey was the Chairman of the Advisory Committee.

U.S. at 348. Thus the Advisory Report concluded that an offering of shares in a residential cooperative or condominium[31] on a "user" rather than "investment" basis does not constitute an offering of securities. *Id.* at 76. Only if an offering involves a rental pool, where a third party undertakes to rent out dwelling units on behalf of some or all of the owners and to distribute the rental income on a pro rata basis, or a requirement that the owner make his unit available for rental for a portion of the year, or some other indication that the units are "being marketed and purchased primarily as an investment," *Id.* at 79, would the securities laws apply.

The Advisory Report explicitly rejected the Court of Appeals' argument that the mere presence of commercial facilities as part of a residential cooperative *per se* turns the offering into a security. *Id.* at 81. On the contrary, the Committee recognized that such commercial facilities are "not atypical" and are included for the benefit of the residents. Thus the Report concluded that if commercial facilities were incidental to a residential project and not the "main financial inducement for purchasing the unit," their existence did not make the offering a security. *Id.*

Finally, the Committee recommended that the SEC abandon the "anachronistic" and "admittedly arbitrary" exemption of Rule 235 and the "legal fiction" upon which

31. The Advisory Report stresses that the form of the transaction, whether cooperative or condominium, should be disregarded:

> "Cooperative dwelling units should be treated in substantially the same manner as condominium units inasmuch as the form of ownership is primarily a matter of local law and preference and represents no substantial difference with relation to the securities laws." *Id.* at 89; *see id.* at 89-91.

it was based, *id.* at 90, and adopt new rules or guidelines to determine

> "when the offering being made is of real estate for personal use and when the offering is of a security with the requisite need to provide the offeree with the protections afforded by the federal securities laws." *Id.* at 76.

Although it has not formally repealed Rule 235,[32] the SEC issued new guidelines embodying the recommendations of the Report. These guidelines, SEC Release No. 33-5347 (P-D5-11), state that an offer of a condominium or similar unit[33] is not a security unless it is promoted on a profit-making rather than personal use basis and is combined with collateral arrangements, such as a rental pool or a required rental period (P-D9-10). The Release also adopts the Committee recommendation that the presence of commercial facilities as an incidental part of a residential cooperative does not turn the project into a security.[34]

The release and the Advisory Report are in accord with the previously published views of the SEC staff. For ex-

32. The SEC staff recently announced that it is re-examining the Rule 235 exemption in light of the Court of Appeals' decision below. Society Hill Towers, Inc., SEC No-Action Letter, Dec. 27, 1974, CCH FED. SEC. L. REP. ¶80,103.

33. The release applies to cooperatives as well as condominiums. As the release states:

> "Although this release speaks in terms of condominiums, it applies to offerings of all types of units in real estate developments which have characteristics similar to those described herein" (P-D6-7).

The Release specifically mentions cooperatives (*see* p. 29, *supra*), and was adopted as a result of the Advisory Report which explicitly rejected distinctions between cooperatives and condominiums.

34. Similarly, under Rule 235, "incidental" commercial facilities do not affect exempt status. 17 C.F.R. 230.235(b).

ample, the staff issued a no-action letter in August 1971 to a developer of a Maryland residential condominium which contained apartment units and commercial facilities on the same site. The developer stated that the members of the condominium would also hold stock in the corporation that owned the commercial facilities (shops, restaurants, a swimming pool and an entertainment area), which, although open to the public, were primarily for the benefit of and as a convenience for the residents of the condominium. Income from the commercial area was to be used to offset common area expenses. The Commission staff concluded that the offering did not involve securities requiring registration even though the offering included instruments called "stock." Clemson Properties, Inc., SEC No-Action Letter, Aug. 13, 1971, [1971-72 Transfer Binder] CCH FED. SEC. L. REP. ¶78,387. *See also* McCulloch Properties, Inc., SEC No-Action Letter, Aug. 30, 1973 (avail. Oct. 1, 1973).

Thus, under published SEC guidelines and no-action letters, a share in Co-op City is not a security. The purchasers are buying dwelling units for personal use, there are no rental pools or required rental periods, the commercial facilities are incidental to the project and not a primary source of income, and the promotional material does not emphasize the economic benefits to be gained from participation in the project.

The Court of Appeals ignored SEC Release No. 33-5347. But the silence of the Court below does not alter the soundness of the guidelines set forth in the Release. For the

purposes of the securities laws, purchases for residential purposes should be separated from investment transactions for profit.

III

This Court Should Not Extend Jurisdiction of the Securities Laws to State Regulated Housing Cooperatives Without a Clear Congressional Mandate.

The federal securities laws are remedial legislation warranting liberal construction to accomplish the statutory purpose. But their blanket application to state subsidized and regulated housing cooperatives intrudes upon an already complex and heavily regulated state statutory scheme without congressional authorization and, in fact, contrary to recent expressions of congressional intent.

A. Low and middle income housing is a matter of great state concern and pervasive state regulation.

Co-op City was built under a housing program adopted by New York State to remedy a severe shortage of "decent healthful housing," to forestall the deterioration of "slum ghetto" neighborhoods, and to improve "the quality of urban life." Housing Law §§11, 11-a(1), (2-a). The New York Legislature viewed this program as "play[ing] a big part in arresting the exodus of families from the cities" and inhibiting the spread of slums. *Note of Comm'n, reprinted at* Housing Law §10 at 9 (McKinney 1962). The Legislature encouraged the cooperative format because of important social benefits to the cooperators and their communities; it believed that cooperative homeownership by

low income tenants would revitalize the quality of urban life and that the "consequent pride and responsibility of ownership" would "lead to the stabilization and renewal of deteriorating neighborhoods." Housing Law §11-a(2-a).

Under the Housing Law, virtually every aspect of a cooperative's development and operation is regulated by the State (P-B6-7).[35] The Commissioner of Housing has broad investigatory powers with respect to supervision of a cooperative's affairs; he may remove and replace a project's directors if they have violated the law, state regulation or the certificate of incorporation. He may sue to prevent such violation—or any act or omission "which is improvident or prejudicial to the interest of . . . the tenants." Housing Law §32(5)-(7).

In addition, New York has a complex statutory scheme of registration and supervision of housing cooperative and condominium offerings. N.Y. Gen. Bus. Law §§352-e, 352-i. The State Attorney-General has wide powers to sanction and enjoin improper conduct, and the state law "anti-fraud" statutes are broad. *See People* v. *Cadplaz Sponsors, Inc.*, 69 Misc.2d 417, 330 N.Y.S. 2d 430 (Sup. Ct. N.Y. Co. 1972).

B. Federal statutes should not be extended to an area of great state concern without a clear congressional mandate.

This Court has long held that federal courts should not construe federal statutes so as to alter significantly the

35. *See* p. 8, *supra.*

federal-state balance—and federalize an area of state law —unless Congress has clearly expressed that purpose. This judicial policy reflects a determination not to interfere with local control and regulation of local problems without congressional direction, and a desire not to strain federal resources, particularly where the states and state courts are competent to act. The policy was clearly enunciated in *United States* v. *Bass*, 404 U.S. 336, 349 (1971):

> "In traditionally sentitive areas, such as legislation affecting the federal balance, the requirement of clear statement assures that the legislature has in fact faced, and intended to bring into issue, the critical matters involved in the judicial decision."

In *Rewis* v. *United States*, 401 U.S. 808, 812 (1971), the Court found that congressional silence as to the effects of legislation on the federal-state regulatory balance "strongly suggests" that Congress did not intend a result that would intrude on the states.

Even in the area of bankruptcy reorganization of railroads, a matter of predominantly federal rather than state concern, the Court has been unwilling to superimpose federal regulation over that of the states without "language fitting for so drastic a change." *Palmer* v. *Massachusetts*, 308 U.S. 79, 85 (1939). Thus, Justice Frankfurter noted that although Congress had in other statutes exercised regulatory authority of a railroad's intrastate activities,

> "such absorption of state authority is a delicate exercise of legislative policy in achieving a wise accommodation between the needs of central control and the lively maintenance of local institutions. Therefore,

> in construing legislation this court has disfavored inroads by implication and resolutely confined restrictions upon the traditional power of states to regulate their local transportation to the plain mandate of Congress." *Id.* at 84 (footnotes and citations omitted)

See also Apex Hosiery Co. v. *Leader,* 310 U.S. 469, 513 (1940).[36]

The Court of Appeals noted that many industries, such as public utilities, which are highly regulated by the states, are also subject to federal regulation and federal jurisdiction under the securities laws (P-A19). But federal regulation of public utilities—and the potential impact on state regulation—was considered by Congress, and a deliberate decision to impose federal regulation was made.[37] By contrast, the securities laws and their legislative histories are totally silent on the subject of housing cooperatives.

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36. *Cf.* United States v. Wittek, 337 U.S. 346 (1949), in which this Court considered whether federal defense housing in the District of Columbia was covered by federal rent control, a remedial law which was literally applicable. The Court found that such a construction would also subject D.C. public housing to rent control. Given the importance of the public housing program and the inconsistency of the rent control law with public housing policy, it was inconceivable, the Court held, that Congress would have intended to subject the public housing program to control of another agency under an act designed to meet wholly different problems without having clearly said so. *Id.* at 357-58.

37. *See* S. Rep. No. 47, 73d Cong., 1st Sess. 4 (1934); *Hearings on H.R. 7852 and 8720 before House Interstate and Foreign Commerce Comm.,* 73d Cong. 507, 667-68 (1934); *Hearings on S. Res. 84 (72d Cong.) and S. Res. 56, 57,* 73d Cong., pt. 15, 7022, *cf.* 6577 (1934).

C. Federal housing legislation is inconsistent with securities law jurisdiction.

Far from issuing a "clear statement" or "plain mandate" that housing cooperatives are subject to the securities laws, Congress has indicated that housing cooperatives should be federally regulated, if at all, by housing laws administered by HUD.

The most direct congressional statement with respect to federal regulation of transactions in cooperative homes is contained in Section 821 of the Housing and Urban Development Act of 1974, 42 U.S.C. §3532. There, Congress directed HUD to conduct a study of the "problems, difficulties, and abuses or potential abuses applicable to condominium and cooperative housing" and to determine whether federal legislation is needed.[38]

The amendment proposing this study was offered on the floor of the House by Rep. Benjamin S. Rosenthal and was adopted without opposition. Congressman Rosenthal proposed the bill because fewer than ten states "have meaningful laws protecting condominium and cooperative purchasers." 120 Cong. Rec. 5371, 93d Cong. 2d Sess. (daily ed. June 20, 1974). The study, which would provide Congress with information to "deal with an issue of growing national concern," would focus on, among other things,

> "the legal and economic factors surrounding condominium and cooperative construction and conver-

38. *See* N.Y.L.J., Jan. 15, 1975, p. 6, col. 6. HUD will report its findings and recommendations to Congress by August 22. The N.Y. Times reports that questions by HUD officials at recent hearings revealed concern about, among other things, federal involvement in real estate transactions in general and about the effect of federal regulation on housing costs. N.Y. Times, Feb. 13, 1975, p. 38, col. 1.

> sion; . . . the social and housing-policy implications of condominiums and cooperatives, and . . . the alleged consumer problems associated with [their] sale . . . and conversions." *Id.* at 5372.

Significantly, Congress did not suggest that the way to prevent sales abuses in cooperatives or condominiums was to call on the SEC to act, or that the securities laws provide a solution. If those laws apply to housing cooperatives, Congress is unaware of it.

Another 1974 statute, the Real Estate Settlement Procedures Act of 1974, P.L. No. 93-533 (Dec. 22, 1974) ("RESPA"), requires substantial written disclosures in virtually all mortgage loan transactions in "residential real property," including private homes and "individual units of condominiums and cooperatives." RESPA §3. It requires, among other things, a standard form for settlement cost disclosure; a descriptive booklet explaining settlement procedures; and, in some cases, a disclosure of certain information about the sales history of the property, to prevent real estate speculation. RESPA §§4, 5, 6; H.R. Rep. No. 93-1177, 93d Cong., 2d Sess. 6, 9 (1974). Significantly, the Act has directed HUD, not the SEC, to issue regulations under the Act, to study the effects of the legislation for three to five years and to report back to Congress on the need for further legislation, if any. RESPA §§4-6, 14.

Congress' unwillingness to apply the securities laws to real estate transactions generally is evidenced by the history of the Interstate Land Sales Full Disclosure Act, 15 U.S.C. §§1701-1720. The early legislative proposals would have applied the 1933 Act to interstate land sales. Although the need for legislation was apparent, those bills were rejected as overly broad and an unnecessary infringe-

ment on traditional state power. As the Department of Commerce noted:

> "The bill would add considerably to the cost of homesites, and put a considerable burden on the Securities and Exchange Commission to administer such legislation effectively." S. Rep. No. 1123, 90th Cong., 2d Sess. 198 (1968) (*cited in* Combined Views of Senators Bennett *et al.*)

As finally enacted, the statute is drawn narrowly. Federal supervisory authority is vested in HUD. 15 USC §1715(a).

Congressional studies of housing problems demonstrate that Congress views cooperative housing as a vehicle for the accomplishment of important social goals. The language used by Congress in emphasizing and encouraging cooperatives is totally inconsistent with their treatment as securities in the commercial marketplace.

Twenty-five years ago, Congress recognized the unique social advantages offered by cooperative housing. Congress noted that the savings effected by the elimination of profit, together with other reductions in costs, make it possible to provide decent housing to lower income families. In reporting out amendments to the National Housing Act (the Housing Act of 1950), the Senate Committee on Banking and Currency, which has jurisdiction over both securities and housing, stated that,

> "[Title III] is designed . . . [so that] soundly conceived cooperative housing projects will be able to secure the low-cost financing essential to reduced monthly charges, and the benefits and savings thereby achieved are, in a cooperative . . . automatically translated into direct benefits to consumers in the form of

> reduced monthly charges. . . . [T]here can be no diversion into speculative profits of the financial economies made possible by the low-cost financing." S. Rep. No. 1286, 81st Cong., 2d Sess. (1950), *in* 1950 *U.S. Code Cong. Serv.* 2021, 2101.

These and other savings would, the Committee stated, "bring good housing within the reach of a substantial number of middle-income families who otherwise cannot obtain it." *Id.* at 2107. *See* S. Rep. No. 892, 81st Cong., 1st Sess. 6, 48-49 (1949). More recently, the National Commission on Urban Problems has viewed the cooperative as a viable solution for the housing shortage for low and lower middle income groups, having substantial advantages over traditional rental housing. *Building the American City, supra,* at 134, 139-42.[39] The housing cooperative produces "a greater sense of community and of belonging," greater racial and religious integration and "pride of ownership." The Commission reported that vandalism, crime and delinquency have been low even in former problem rental projects; and mortgage and maintenance records have been excellent. *Id.* at 141-42.

D. Congress is best suited to decide whether and in what manner housing cooperatives should be federally regulated.

The decision whether to subject transactions in cooperative homes, particularly state financed and regulated cooperatives, to federal law should be made by Congress, not the courts. Congress is the institution best equipped

39. The Commission, headed by Senator Paul H. Douglas, was created by Congress and the President to study and recommend ways "to increase the supply of low-cost decent housing," among other things. *Id.* at vii.

to resolve the many complex issues which arise when fashioning a balance between federal and state interests.

Congress, not the courts, is best equipped to determine the nature and scope of the substantive law, if any, needed to regulate cooperative housing.

Congress, not the courts, is best equipped to decide whether state regulation is to be entirely superseded, or whether such regulation is to control where it is sufficiently thorough.[40]

Congress, not the courts, is best equipped to decide whether the federal courts should be opened to litigation between developer and purchaser or between private seller and purchaser and if so, whether such jurisdiction should be exclusive or concurrent with state courts.[41]

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40. *See, e.g.,* Section 123 of the Truth-in-Lending Act, 15 U.S.C. §1633, under which certain credit transactions can be exempted if, under applicable state laws, those transactions are "subject to requirements substantially similar to those under this part" and are adequately enforceable.

Moreover, the states' traditional interest in housing has been consistently recognized and reaffirmed by Congress in its housing legislation. *See, e.g.,* RESPA §§14(b)(3), 18, and S. Rep. No. 93-866, 93d Cong., 2d Sess. 5 (1974), which rejected direct federal regulation of settlement cost rates because it "would infringe on an area that has historically been of state or local concern" and would duplicate some existing state regulatory schemes; the Housing and Community Development Act of 1974, §§101, 201(a), 802(a), 42 U.S.C. §§5301, 1437, 1440(a); 42 U.S.C. §3532(b), which requires the Secretary of Housing and Urban Development to consult and cooperate with the states with respect to community development problems. The National Commission on Urban Problems found that "the States have tended to become forgotten members of the governmental family" and recommended decentralization of urban development programs. *Building the American City, supra* at 29-30.

41. *E.g.,* in RESPA §16, Congress provided that suits to recover damages under §§6, 8 or 9 may be brought in federal or state court

(footnote continued on next page)

Congress, not the courts, is best equipped to decide whether to require a jurisdictional amount and whether other securities law concepts such as national service of process, expansive venue, and invalidity of arbitration clauses are appropriate.[42]

Subject to constitutional limitations, Congress is best equipped to decide the extent to which state governments and agencies are to be subject to suit under the legislation it enacts.

There are other careful distinctions to be drawn and problems to be considered in any decision to proceed with federal regulation of the sales of housing cooperatives, particularly state subsidized and regulated cooperatives. Such matters are peculiarly legislative in nature and warrant congressional deliberation. As this Court has stated, pleas for the expansion of federal jurisdiction into "hitherto uncovered broad categories of litigants ought to be made to the Congress and not to the courts." *United Steel Workers of America* v. *R. H. Bouligny, Inc.*, 382 U.S. 145, 150-51 (1965). *See also Shamrock Oil & Gas Corp.* v. *Sheets*, 313 U.S. 100 (1941).

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within one year of the violation. If the decision below is sustained, it is to be expected that homeowners with housing complaints who have even the slimmest chance of establishing a 10b-5 claim will sue in federal court and assert all of their other claims under the doctrine of pendent jurisdiction—a practice which was followed in this very case and which in earlier cases generated criticism from the courts. Ryan v. J. Walter Thompson Co., 453 F.2d 444, 445 (2d Cir. 1971), *cert. denied*, 406 U.S. 907 (1972); Kavitt v. A. L. Stamm & Co., 491 F.2d 1176, 1178-79 (2d Cir. 1974).

42. Under the decision below, the rule of Wilko v. Swann, 346 U.S. 427 (1953), will render unenforceable agreements to arbitrate disputes arising out of the purchase or sale of cooperative or condominium residences, thus adding to the prospective burden of federal litigation and further upsetting a traditional and encouraged manner of resolving such disputes.

Respondents ask this Court to impose by judicial decision, without express or implied congressional sanction, a complex and costly federal regulatory scheme upon a state regulated housing cooperative. Here, Congress has clearly indicated that such results were not intended. Congress has referred the question of federal regulation of housing cooperative sales to HUD for report and possible legislative action. This Court should respect that legislative decision and decline to intercede.

Conclusion

This case involves the purchase of cooperative homes under a state subsidized and regulated nonprofit housing program with respect to which profit incentives are totally absent. The Court below held that the documents reflecting the ownership of these homes are securities within the meaning of the securities laws and therefore entitle the purchasers to litigate their grievances in federal court.

That decision is contrary to the purpose and intent of the securities laws and the decisions of this Court and of other circuit courts. It is inconsistent with recent SEC guidelines and congressional action in the field of cooperative housing. It effects a sweeping expansion of the scope and coverage of the securities laws, undermines SEC guidelines, vastly expands the number of kinds of disputes which may be litigated in federal courts and extends securities law jurisdiction into an area of traditional state concern and regulation at the very time Congress is considering an entirely different approach to potential problems in housing cooperatives.

Perhaps most importantly, however, the Court below failed to recognize that the securities laws, though to be broadly construed to effect their remedial purpose, cannot and should not be utilized to solve problems with which they were not designed to deal. The securities laws were enacted to protect investors in the commercial marketplace, not consumers in the housing marketplace; they cover securities, not homes. The overly broad construction given by the Court of Appeals makes the securities laws, in effect, a general catch-all for all kinds of complaints and problems quite alien to the statutes' scope and original intendment.

The decision below should be reversed and the case dismissed for want of subject matter jurisdiction. Respondents should be required to air their housing grievances by pursuing the ample remedies available to them in the courts of the State of New York.

Dated: New York, New York
March 6, 1975

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APPENDIX

APPENDIX

Statutes, Rule, and Release Involved

The statutes involved in this case are 15 U.S.C. §§77b(1), 77q, 77v(a), 78c(a)(10), 78j(b), and 78aa, which provide as follows, in pertinent part:

15 U.S.C. §77b [Sec. 2(1), 1933 Act]

When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. §77q [Sec. 17(a), 1933 Act]

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make

the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past of prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

15 U.S.C. §77v(a) [Sec. 22(a), 1933 Act]

(a) The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took

place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States. No costs shall be assessed for or against the Commission in any proceeding under this subchapter brought by or against it in the Supreme Court or such other courts.

15 U.S.C. §78c(a) (10) [Sec. 3(a)(10), 1934 Act]

(a) When used in this chapter, unless the context otherwise requires—

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Statutes and Rule

15 U.S.C. §78j (b) [Sec. 10(b), 1934 Act]

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. §78aa [Sec. 27, 1934 Act]

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant

may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts.

17 C.F.R. 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.